ReedSmith

Independent Commission on Banking's Final Report – September 2011

Author: Jacqui Hatfield, Partner, London
Author: Melissa Peters, Associate, London

Publication Date: September 27, 2011

Overview

On 12 September 2011, the Independent Commission on Banking (the "**ICB**") published its *Final Report* in which it sets out its recommendations for banking reform in the UK. The *Final Report* indentifies two broad areas of reform: (i) financial stability, and (ii) competition. Below is a summary of the key messages contained in the *Final Report.*

Background to the report

The ICB was established by the government in June 2010 to consider the options for the reform of the UK banking system. It was asked to report to the Cabinet Committee on Banking Reform by the end of September 2011.

In April 2011, the ICB published its *Interim Report* in which it set out its provisional views on reform. The *Final Report* builds on the *Interim Report* and the responses to the ICB's consultation on reform options. The ICB's final recommendations emerge against a backdrop of sovereign debt problems and general economic weakness in the UK and Europe.

Reforming the structure of the banking industry

In the *Final Report* the ICB proposes two key reforms to the structure of the UK banking sector: (i) the ring-fencing of vital banking services, and (ii) increased loss-absorbency.

The ICB recommends the ring-fencing of retail banking from wholesale/investment banking on three main grounds. First, it argues that ring-fencing would make it easier to assist banks which get into trouble without the provision of taxpayer support. Second, it would protect the vital banking services on which households and small to medium-sized businesses depend. Third, it would reduce the risk to the public finances by removing the expectation of government bail outs across the industry, which in turn will make it less likely that banks will take excessive risks in the first place. The ICB proposes a high ring-fence around vital banking services which would contain all deposits and overdrafts from and supplied to individuals and small to medium-businesses. Ring-fenced banks would be prevented from engaging in investment banking activities and from providing services to financial companies and customers outside the EEA.

Alongside the ring-fencing recommendations, the ICB proposes that banks should be forced to increase their loss-absorbing capacity. It is the ICB's view that, by requiring banks to hold more capital relative to their assets, risk can be transferred away from shareholders (and taxpayers) and onto creditors. Whether capital measures should go beyond the requirements of Basel III (the sequence of reforms to the international framework for capital requirements introduced by the *Basel Committee on Banking Supervision*) is discussed at length in the Final Report. The ICB concludes that stricter loss-absorbency measures than those brought in under Basel III are required to bring long-term stability to the UK banking industry. In particular, it recommends that large ring-fenced banks should maintain equity of at least 10% of risk-weighted assets. In the *Final Report*, the ICB insists that the structural reforms proposed in the *Final Report* would have addressed the failures of each of the prominent casualties of the 2007-8 financial crisis, and will reduce the risk of another major collapse.

Enhancing competition in the retail sector

The *Final Report* emphasises the need to promote competition within the retail banking sector; a market which has become considerably more concentrated over the past decade. In the ICB's view, reform of the regulatory framework within which competition takes place is fundamental to improving the overall competitiveness of UK retail banking. The ICB recognises the potential impact of the Lloyds Banking Group ("**LBG**") divesture and recommends that the Government seek agreement with LBG to ensure that the divesture leads to the creation of a strong and effective challenger bank. The ICB also suggests several ways in which to improve transparency in the retail banking market and to make it easier for customers to switch between different accounts and/or banks. For example, the *Final Report* recommends the introduction of a redirection service for customers wishing to switch accounts, which would automatically transfer all credits to and debits from previous accounts for up to a year. The ICB stresses that measures such as this are necessary in order to enhance the competitive pressure on banks through customer choice.

Implementation timetable

The ICB has urged the government to move quickly to implement the recommendations of the *Final Report* through legislation and regulatory rules. It proposes a full implementation of the ring-fencing and loss-absorbency recommendations by 2019, in line with the Basel III timetable. It remains to be seen whether the government will act quickly to introduce the ICB's proposals, particularly in light of the weakness of economic recovery and the recent pace of international regulatory reform.

Comments

The ring-fencing requirement is much vaguer than expected, giving the banks flexibility to decide what is inside and outside the ring-fence. They also have until 2019 to implement structural changes (after the next election and following Basel III implementation). Hopefully this will give banks time to lobby for any changes required to suit their business requirements.

Despite the flexibility, I am concerned that ring-fencing will make the UK uncompetitive against its global peers. The structural changes will be costly for banks to implement and wholesale funding to investment banking divisions will have an effect on lending.

It will be difficult for the retail banks to make profit margins because they will find it harder to attract large corporations on the basis that there will be retail depositor preference, which would effectively make large corporations subordinated creditors in the event of an insolvency. It is likely that the cost of services which are currently provided for minimal fees, such as custody, will rise as a result. They will also find it difficult to compete with overseas banks which are not subject to the ring-fencing requirement.

The requirement for retail banks to hold 10% core equity against their assets, when Basel III reforms require 7%, is an issue for concern. For global reform to work, it needs to be uniformly implemented. The result of these proposals will be the creation of more fragmentation, which is not desirable.

Whilst ring-fencing should assist with the ‘too big to fail' issue (although I assume that the majority of a bank's activities are likely to fall within the retail ring-fence) it should be remembered that Northern Rock and Bradford and Bingley would have fallen within the retail ring-fence.

I am pleased to see competition highlighted as an issue in the report. More competition is required in the UK. However, higher capital requirements and more compliance and reporting requirements will act as barriers to competition.

Corporate governance is key to ensuring banks do not take excessive risks and that another banking crisis does not occur - not ring-fencing. Corporate governance was not addressed sufficiently in the *Interim Report* and neither is it addressed sufficiently in the *Final Report.*

ReedSmith

About Reed Smith

Reed Smith is a global relationship law firm with more than 1,600 lawyers in 23 offices throughout the United States, Europe, Asia and the Middle East.

Reed Smith LLP is a limited liability partnership registered in England and Wales with registered number OC303620 and its registered office at The Broadgate Tower, 20 Primrose Street, London EC2A 2RS. Reed Smith LLP is regulated by the Solicitors Regulation Authority. Any reference to the term 'partner' in connection to Reed Smith LLP is a reference to a member of it or an employee of equivalent status.

This Client Alert was compiled up to and including September 2011.

The business carried on from offices in the United States and Germany is carried on by Reed Smith LLP of Delaware, USA; from the other offices is carried on by Reed Smith LLP of England; but in Hong Kong, the business is carried on by Reed Smith Richards Butler. A list of all Partners and employed attorneys as well as their court admissions can be inspected at the website **http://www.reedsmith.com/**.